

Part I

Section 355.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355-3: Active conduct of a trade or business.

Rev. Rul. 2003-18

ISSUE

Whether the acquisition by a dealer engaged in the sale and service of brand X automobiles of a franchise to sell and service brand Y automobiles and the assets to operate the franchise constitutes an expansion of the brand X business rather than the acquisition of a new or different business under § 1.355-3(b)(3)(ii) of the Income Tax Regulations.

FACTS

Corporation D has been engaged under a dealer franchise in the sale and service of brand X automobiles since Year 1. For over five years before Year 8, these operations had been carried on in two buildings (L and M) within the same city. In Year 8, D acquired a franchise for the sale and service of brand Y automobiles and purchased the inventories, equipment, and leasehold of a former brand Y automobile dealer who operated in a building adjoining D's building L. Shortly thereafter, D relocated the inventory of brand X automobiles from building L to building M.

Thereafter, D used building M exclusively for the sale and service of brand X automobiles and used building L and the adjoining leasehold exclusively for the sale and service of brand Y automobiles.

In Year 10, D transferred all of the assets, including building M, and liabilities of the brand X automobile dealership to a new corporation, C, in exchange for the stock of C, and distributed the stock of C pro rata to its shareholders.

LAW AND ANALYSIS

Section 355(a) of the Internal Revenue Code provides that a corporation may distribute stock and securities in a controlled corporation to its shareholders and security holders in a transaction that will not cause the distributees to recognize gain or loss, provided that, among other requirements, (i) each of the distributing corporation and controlled corporation is engaged, immediately after the distribution, in the active conduct of a trade or business, (ii) each trade or business has been actively conducted throughout the five-year period ending on the date of the distribution, and (iii) neither trade or business has been acquired in a transaction in which gain or loss was recognized, in whole or in part, within the five-year period. Sections 355(b)(1)(A), 355(b)(2)(B), and 355(b)(2)(C).

In determining whether an active trade or business has been conducted by a corporation throughout the five-year period preceding the distribution, the fact that a trade or business underwent change during the five-year period (for example, by the addition of new or the dropping of old products, changes in production capacity, and the

like) shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business. Section 1.355-3(b)(3)(ii). In particular, if a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such character as to constitute the acquisition of a new or different business. Id.

In Example (8) of § 1.355-3(c), corporation X had owned and operated hardware stores in several states for four years before purchasing the assets of a hardware store in State M where X had not previously conducted business. Two years after the purchase, X transferred the State M store and related business assets to new subsidiary Y and distributed the Y stock to X's shareholders. Citing § 1.355-3(b)(3)(i) and (ii), the example concludes that X and Y both satisfy the requirements of section 355(b).

In this case, because (i) the product of the brand X automobile dealership is similar to the product of the brand Y automobile dealership, (ii) the business activities associated with the operation of the brand X automobile dealership (i.e., sales and service) are the same as the business activities associated with the operation of the brand Y automobile dealership, and (iii) the operation of the brand Y automobile dealership involves the use of the experience and know-how that D developed in the

operation of the brand X automobile dealership, the brand Y automobile dealership is in the same line of business as the brand X dealership and its acquisition does not constitute the acquisition of a new or different business under § 1.355-3(b)(3)(ii). Instead, it constitutes an expansion of D's existing business. Accordingly, each of D and C is engaged in the active conduct of a five-year active trade or business immediately after the distribution. See § 1.355-3(c), Example (8).

HOLDING

The acquisition by D, a brand X automobile dealer, of the brand Y automobile dealership constitutes an expansion of the brand X business and does not constitute the acquisition of a new or different business under § 1.355-3(b)(3)(ii).

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 57-190, 1957-1 C.B. 121, is obsoleted as of January 5, 1989.

DRAFTING INFORMATION

The principal author of this revenue ruling is Lisa S. Dobson of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling contact Ms. Dobson on (202) 622-7790 (not a toll-free call).